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FCIC memo of staff interview with Sarah Dahlgren, New York Fed

Sarah J. Dahlgren

Shari Leventhal

Michael Patrick

Dixie Noonan

Clara Morain

MEMORANDUM FOR THE RECORD

Event: Sarah Dahlgren

Type of Event: Group interview, not taped

Date of Event: April 30, 2010

Team Leader: Dixie Noonan

Location: Federal Reserve Bank of New York, 33 Liberty Street, New York, NY

Participants - Non-Commission:

- Sarah Dahlgren
- Shari Leventhal
- Michael Patrick

Participants - Commission:

- Dixie Noonan
- Clara Morain

Date of MFR: April 30, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

Dixie opened the meeting by summarizing the FCIC's mandate and explaining that the FCIC is interested in learning about the causes of the problems at AIG. She then asked Ms. Dahlgren to provide an overview of her educational and professional background.

Ms. Dahlgren came to the NY Fed through a program that recruited Masters-level candidates. She worked in a number of roles in bank examination and supervision, with responsibility for supervising the Bank of New York Mellon, Chemical Bank, and Citi at different times. In 1995, she became Staff Director in the NY Fed's policy area focused on the condition of foreign banks. She ran the NY Fed's Y2K readiness program from 1997 until 1999, after which time she took on responsibility for the bank's credit risk management function. After a reorganization in 2000, she took responsibility for large complex organizations including JPMorgan, Bank of New York Mellon, Citi, Chase Bank, and others, and worked as the senior person heading examiners going into those institutions. In 2005, she became responsible for large financial institutions including Wells Fargo Bank, Wachovia, State Street, and others.

At noon on September 16, 2008, she said that she received a call from then-NY Fed President Tim Geithner asking her to go to AIG because the NY Fed was going to be making the company a loan.

“That weekend, I was here working on Lehman... I was up all weekend until Tuesday morning, hoping I could go home early. And that didn’t happen for another 7-8 months,” she said. She said that until January 2010, she was in charge of the Maiden Lane transactions.

Dixie asked if Bear Stearns and Merrill Lynch also fell within the scope of her responsibility prior to focusing on AIG, and she said yes.

Dixie asked Ms. Dahlgren if she was involved in any discussion of why the government should or should not step in to help AIG, and she said no. “Once the decision was made that afternoon to make the loan, it was about pulling a team together to monitor what was the largest loan I had ever made. We had a good sense of what we’d need to do. But by Tuesday, the number was $14 billion, and the question was where’d that money go? And so we started identifying issues within people’s expertise. Wednesday morning, I went in once I’d met with Ed Liddy, and had a meeting with all of the senior managers basically [to give the message that] we [the NY Fed] are here, you’re going to cooperate. And there was full cooperation with company. They were terrified, they were on the brink, and then they were dealing with their lender.”

Dixie asked Ms. Dahlgren if she was involved when AIG initially said they did not need a facility and then quickly revised their estimate to $14 billion. “Yes, that was me,” she said. “Early in the day, they said they’d be ok. But the facility had been set up, the demand note signed, otherwise though there was no term sheet, no real lending documentation. But when they said $14 billion, we literally trucked in collateral from 70 Pine.” She explained that most of the money drawn from the facility went to securities lending counterparties. Dixie asked how much money was drawn from the facility between September 16 and November 10 when the Maiden Lane transactions were announced. Ms. Dahlgren said “north of $60 billion, but I’d have to verify that. This was one of the things really driving us – if you don’t fix the sec lending or the CDOs, they’d blow through the $85 billion. So we needed to stop the sucking chest wound in this patient,” she said.

Dixie asked if the problems in the securities lending program and the Financial Products division were comparable. “I think they were both pretty substantial, but the sec lending counterparties were a big liquidity problem. The two big liquidity drains were CDOs and sec lending, but there are other uses [for the facility] – the GIC counterparties, for example. Going through, that you cannot say it was all FP. You might say it was one of the sources, but AIG also had other problems,” she said.

Dixie asked if Ms. Dahlgren could comment on the potential impact of an AIG failure on the financial system as a whole, and whether or not the NY Fed’s considerations changed between September and November. “Each time we looked at the situation, we had to continue to re-articulate and reaffirm that the situation was serious that a failure of AIG would have a really undesirable outcome,” she said. “And it wasn’t getting better… We went into it knowing that it [the lending program] would need to be adjusted. You have a potential to draw on $85 billion of secured financing – so you look at the company and say ‘you can’t [sustain] this.’ That’s why we needed to fix these other issues in order to try to minimize the amount of money [paid by taxpayer]. It wasn’t just AIG – it was the financial markets. It felt like looking into the abyss. Looking at AIG just showed how bad the market was. It kept getting worse, and worse and worse. The problems were building and building and building because the markets were getting worse and worse and worse. All of the write-downs on [AIG’s] other assets and other sources of its investments really took a pounding with the markets. We were constantly dealing with the fact that as the markets got worse, AIG was worse off, so we had to address concerns about the capital structure of the company and at the same time, we were– rethinking, what's the impact here and what's the impact of an AIG failure."

Dixie asked Ms. Dahlgren what her opinion was of the impact on the financial system of an AIG failure. "Looking at it a couple ways and not having a lot of background in the company of AIG, but seeing a range of trading counterparties… they [AIG] touch every business in the country. They touch Main Street. The company is everywhere, everywhere," she said.

Dixie asked Ms. Dahlgren to comment on the main problems with risk management and the corporate control structure at AIG, given her background in bank supervision. "I can speak to what we saw when we walked in I can speculate how it got there," she said. "[I walked] into a company as decentralized as AIG with a total lack of information at the corporate center. Ed Liddy doesn't know what he's faced with because there was no centralized corporate reporting. Contrast that with walking into most of your banking regulatees – the corporate center knows what's going on. At AIG you have the Treasury not really knowing what they're going to borrow – that's a great example of a company as large as AIG – you'd expect it to know what's going on. Coming into the company and saying 'what am I looking at' in terms of financial systems, compensation, risk management – none of that's centrally reporting up - that's a pretty key piece of it in terms of a real weakness of the company," she said.

Dixie asked if she had any interaction with the OTS. "There were some interactions with the OTS in terms of describing what we're doing. We went into it as a lender; we never talked about supervisory things. Everything was all from the lender perspective." Dixie asked if she ever had a conversation where they discussed how the company reached a point where there was no centralized communication or reporting. She said, "I never had that conversation with the OTS."

Dixie asked if she had any interaction with the AIG Board of Directors. "One piece of the credit agreement was our ability to sit as board observer, and I sit as observer on the Board so that we're comfortable with the corporate governance of the company. So I sit in on all Board and committee meetings. What's most interesting is observing the differences between the old Board and the Board that was brought in June. After a lengthy search, about three fourths of the board was replaced, and a lot of titans were brought in. There are differences in dialogue – it's, from my perspective, night and day. Now you see a Board that demands rigor from management, that demands preparation, better answers. And they dig, which from my perspective is very good to see. You want your Board to set the right parameters for management, the right business parameters, and the right risk parameters. And the difference was huge."

Dixie asked Ms. Dahlgren if she worked directly on liquidity issues. She said, "Week one was very much about assessing the company, about figuring out where the big risks were and where our money was going, and identifying the resources we needed. By Wednesday night, it was clear that we needed boots on the ground. On Thursday, I called E&Y so by Thursday I had them with us. Over that weekend, we were doing valuation on that and looking at all the collateral. Week one was: 'Make sure we're secured, figure out the problems, and map solutions.' The second week, we started hearing from constituents, rating agencies, insurance regulators, [we worked to] figure out their issues. The second week I also went to the AIC National Conference and spoke about our role, that we [the NY Fed] would be working with them [AIG]. Their [AIC members] concern was that we would take over their responsibilities, and my job there was to explain that we were the lender. During this time, I was also getting calls from ratings agencies trying to get the story - they're very concerned, they really didn't understand what was going on, and so we spent a considerable amount of time [with them]. It was clear that they were nervous…" She said that by the end of the second week, there was a plan in place to repay the Fed, Ms. Dahlgren and her team had lined up all bankers, had determined what the assets were, and then determined that they needed an investment bank to help, and so they lined up Morgan Stanley to assist the effort.

Dixie asked if it was a challenge to pick which investment bank the NY Fed would enlist, and she said that by the time they reached out, the choice was basically Goldman Sachs or Morgan Stanley, and Goldman Sachs would have created clear conflicts. Dixie asked who she and her team spoke with, and she said that Jim Head, Ruth Porat, Bob Scully, Eric Bishop and Jared Abbey were among the people they contacted. "There was a huge meeting that weekend with DPW, Morgan Stanley and Ernst & Young where we were there walking through the options. We went through the options, and this then is how we spent the following weeks - talking about what if you guarantee the entire company, what if you guarantee FP only, what if you do a Keep Well, etc. And we went through potential ramifications of the options. By October 8, we had in place a securities lending facility. We knew that would be temporary, and then we worked to come up with more permanent solution, and that ended up being Maiden Lane 2," she said. "Continuing to work with the company, one of the things we didn't want to do was show all our arsenal to the company. If there could've been a Street solution to any of it, that would've been preferable, so we wanted them to keep negotiating. And we heard from Liddy each day about the negotiations. It faced pretty clearly serious difficulties, but we didn't know whether something was actually possible so we wanted them to keep negotiating," she said.

She said that the concept for Maiden Lane 2 came up in the following weeks during discussions about permanent solutions. She said the team worked with legal and with the company to determine the transaction's feasibility, and then worked with the company to get management comfortable with the deal. "EESA passed early October, and it wasn't until late October that things became more clear about the possibility of putting capital into AIG. It was a thing a fate. The thought was that Neel Kashkari would take the assets, and he said no, so we went back to drawing board. There were fateful Halloween discussions with Treasury about investment, how much was needed, and then there was immense back and forth about showing rating agencies what the possibilities were of Maiden Lane 2. We weren't going to do this unless they maintained the ratings. We weren't going to execute on the deal unless they maintained the ratings. So there was a lot of finessing," she said. Dixie asked if there was any contractual agreement from the ratings agencies about maintaining the ratings, and she said no.

Dixie asked if she worked with Mr. Geithner, and whether or not she was the interface with the ratings agencies and the Federal Reserve Board. "I was one of the interfaces, I worked with staff, with Tim and I and the team talking to the relevant Governors." Dixie asked how involved the Board of Governors were with the discussions about AIG solutions. She said the Board was "very involved. Everything we do is under their direction. We had to show them why we needed to do what we needed to do."

Dixie asked how the Lehman bankruptcy impacted the AIG solutions, if at all. "That was the beginning," she said. "One of the issues was with how AIG was pricing on CDOs – Lehman was a source [of AIG's marks], and AIG was using Lehman to contest prices with Goldman and others. They also had some exposure to Lehman and wrote off a couple hundred million. It wasn't consequential in the scheme of things. But it was the end of the private sector solution."

Dixie asked if there was any disagreement within her team about the ultimate solutions. She said no, and Ms. Leventhal added, "There was no choice." Ms. Dahlgren said, "and we tried. And then it was like, 'there's not time – we've got to go in this disagreement. In retrospect, we wouldn't have done anything differently given the situation. Once the Government made the decision to intervene, our view was that you couldn't *not* continue to support AIG and risk the credibility of the United States. Once the decision was made, we continued to look at AIG, the impact of failure on counterparties, customers etc., but at the same time, there was a financial meltdown, and the United States Government not continuing to do what it said it would do on Sept. 16 was not… the credibility of the United States Government was on the line."

Dixie asked if the NY Fed considered cutting off its assistance after the $85 billion facility. She said, "the practical process of bankruptcy for a company like AIG… you stop a company like this, the flows in and out of this company, I can't tell you how many people stop getting paid. The systemic risk which continued, and then with the issue of the US Government, it's just…"

Ms. Leventhal said that there was not simply a commitment to provide $85 billion, but rather, "there was a commitment to stabilize the company. There was a commitment to support AIG. Even without the explicit parameters being set. But breaking that commitment had systemic implications of its own."

Dixie asked if Ms. Dahlgren could comment based on her expertise of AIG on what the FCIC should focus on to understand clearly why AIG failed. She said, "Well, the company was very complicated - does it have to be that way? I think that's something worth taking a look at. The Board of Directors, there are good questions to ask there. . . I don't know what happened up to that point, but the differences between the old and new Board lead me to think there might have been more oversight there. So I think corporate governance is an interesting question. I'd also look at supervision of a company like that. Complexity, governance, oversight of the Board, risk management and centralized control – those are the issues here." She added that it would be worth looking at why investment decisions were made in the insurance subsidiary, how traders at AIG FP were compensated "which was I think inappropriate, and how incentives were designed throughout the company. The insurance businesses are actually pretty good and have some strong people – we saw that when we started paying more attention to insurance. It was good to get good news. I'd also talk to Hank Greenberg if you have a chance," she said.

Dixie said that the FCIC may have follow-up questions, thanked Ms. Dahlgren for her time, and concluded the interview.